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SUBJECT: CHARGE CALLS ON KEY GRP FINANCIAL OFFICIALS

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Summary

1. (SBU) In separate meetings with the Charge, both Central Bank Governor Tetangco and the Finance Secretary Teves described what they see as good prospects for steady economic growth, financial stability, and continued progress on fiscal reforms. Tetangco, in particular, downplayed recent "political noise" and attributed any weakness in the peso almost exclusively to uncertainty over the Supreme Court's ruling, expected soon, on the expanded VAT. Both Tetangco and Teves expressed confidence that the expanded VAT would meet with court approval. Teves said he was very pleased that the Philippines could become a Millennium Challenge Account (MCA) Threshold Country. Tetangco and Teves stated their strong commitments to fiscal reform and anti-corruption efforts. Tetangco underscored his commitment to maintain progress on anti money-laundering, especially as a recent Egmont Group member. These two key financial officials will be in New York in mid-September when President Arroyo is at the UNGA meetings, and both will be meeting with members of the financial community to try to boost confidence in the Philippine economy. Teves is intensely focused on fiscal reforms, especially improving revenue collection, and less on "business climate" issues outside of the DOF's immediate territory. End Summary.

Participants

2. (U) -- U.S. Participants at Central Bank and DOF Meetings: The Charge, USAID Director Jon Lindborg and Economic Counselor Robert Ludan.
-- GRP participants at Central Bank: Governor Amando "Sy" Tetangco and Deputy Governor Diwa Guinigando.
-- GRP participants at DOF: Finance Secretary Margarita "Gary" Teves and Deputy Secretary Roberto Tan.

Central Bank Governor Sees 5 Percent GDP Growth in 2005

3. (SBU) In the Charge's August 25 call, Amando Tetangco, recently appointed Governor of the Bangko Sentral ng Pilipinas (BSP), noted that the overall macroeconomic numbers looked good. GDP growth in the first quarter was 4.6 percent and the still unannounced figure for the second quarter appeared to be about the same. Surging oil prices had the effect of reducing initial 2005 growth estimates to the lower end of the forecast range (5.3 percent - 6.3 percent), but growth of about 5 percent for the entire year would be "respectable" in view of oil prices, according to Tetangco. The balance of payments situation for the first half of 2005 was in surplus by about \$1.9 billion due to stronger than expected remittance inflows, up 21.5 percent in the first half, though initially projected to grow by only 10 percent. The \$10 billion in remittances in 2005, compared to \$8.5 billion in 2004, would offset the higher cost of oil on the balance of payments. Tetangco explained that the market response to higher oil prices was much quicker than expected and demand had already declined. The GRP has already funded the National Power Corporation (NPC) through the end of the year so the current account surplus was set to increase. Barring an "accident," Tetangco predicted the current account, at year's end, would remain in surplus by \$850 million, which would be higher than initial forecasts.

4. (SBU) Turning to exchange rates, Tetangco noted that BSP reserves were \$17.7 billion and that the peso, trading at about 56 pesos/dollar that day, would be slightly stronger, perhaps about 54 pesos/dollar, if it were not for current

political uncertainties. He noted that the peso had traded at 53 pesos/dollar on July 1 prior to the temporary restraining order and Supreme Court review, which froze implementation of the expanded VAT. The pending Supreme Court decision on the VAT, however, was a much more important factor than the recent "political noise," which the markets tended to ignore, according to Tetangco. Markets and the BSP now expect a favorable decision on the expanded VAT and slight strengthening of the peso. If the Supreme Court decision strikes down the expanded VAT, Tetangco admitted that markets would react negatively and that the GRP and the BSP would have to redirect their attention to stimulate stronger economic demand and growth.

15. (SBU) Tetangco said that the BSP does not target a specific exchange rate for the peso. The peso trades within a range of values against the dollar. The BSP, however, would work to counteract "sustained unidirectional movement" in the currency. "We want orderly exchange rate adjustment," he said. The foreign exchange rate should be "basically market-determined." "We do not want volatility." He insisted that the BSP had not engaged in large scale intervention to prop up the currency during the recent political turbulence and commented that there had been no such need. He pointed out that central bank reserves were at an all time high, \$17.7 billion, indicative of non-intervention.

Banking Sector Reforms

16. (SBU) BSP has continued to work with the commercial banks to clear out bad assets and reduce nonperforming loans. The BSP plans to strengthen the capital position of the banks to ensure that they move to Basel II standards by 2007. The BSP is working with the Congress on legislation that would amend the BSP charter and, separately, upgrade the availability and quality of credit information for the banking system. Under current conditions, the lack of reliable credit information penalizes creditworthy borrowers. The BSP is also seeking legislation that would update the legal framework for bankruptcy cases. The current bankruptcy law dates back about one-hundred years to the early 20th Century and, he said, overprotects large creditors and borrowers. Other needed legislation includes pension fund reforms that would encourage higher savings rates.

Nonperforming loans

17. (U) The NPL situation has improved significantly over the last year, with BSP data indicating a peak of 18.2 percent of credit assets in the NPL category in October 2001 but a current level of 9.2 percent. The goal is to reduce the level to 5 percent, where it was prior to the Asian financial crisis. Removing an additional 100 billion pesos in NPLs in the coming year would reduce the rate to 7 percent. Housing loans are beginning to support new construction and overseas foreign workers (OFWs) and other overseas Filipinos have recently shown strong interest in the housing market, though still on a small scale.

18. (U) Capitalization is generally high in the banking system, but certain banks are weak, according to Tetangco. The BSP is encouraging mergers among the banks, and the broad goal is to have fewer but bigger banks. At present, 42 domestic and foreign commercial banks operate in the Philippines, of which about 20 are foreign (including Citibank, JP Morgan Chase, and Bank of America). Only ten of the banks are authorized to operate branches. Citibank and HSBC have acquired savings banks here to enter the retail banking market.

19. (U) Tetangco asked if it might be possible to establish remittance centers in the United States to facilitate such flows to the Philippines. The BSP is seeking ways to reduce the transfer fees for remittances. The Charge replied that each state may have different rules with respect to capitalization requirements and other standards for such enterprises and that such centers would have to consider the rules in each state. Deputy Governor Guinigando explained that the average remittance transfer is about \$400 and that the average fee is 3-4 percent of the amount transferred. Singapore appears to be the most efficient at a cost of 1.4 percent, with average transfers of about \$200, while Italy is the most expensive at 5 percent.

Commitments on Anti Money-Laundering

110. (SBU) The Charge noted that a weak banking system could encourage money laundering. Tetangco confirmed that the BSP, as it works on financial sector reforms, is determined to

continue to strengthen its Anti-Money Laundering Council (AMLC) and that AMLC is strongly committed to its work. He thanked the Charge for USG recognition of the Philippines' progress on anti-money laundering and support on its Egmont membership. Deputy Governor Guinigando noted that AMLC has recently closed some accounts in Philippine banks because of suspicious transactions originating in the U.S. that proved to be innocent. He added that even when the suspicions are cleared, those Philippine banks encounter difficulties with future transfers from the U.S. to the Philippines. The Charge offered to try to help if the BSP can provide specifics, which Guinigando said he would do.

Back Taxes Owed on Foreign Currency Accounts

11. (SBU) Tetangco expressed the hope that the Bureau of Internal Revenue (BIR) would favorably interpret the law to allow tax exemptions for the foreign currency deposit units (FDCU) of the banks for the period 1997-2003. He said that he believed the authors of the 1997 comprehensive tax reform law did not intend to eliminate tax exemptions for FCDUs during the period in question. Tetangco stated that the Congress needed to clarify the intent of the legislators in 1997. The Charge stated that progress on this issue would help to improve investor confidence in the regulatory environment and in the consistency of tax laws.

Tax Evasion

12. (SBU) Tetangco said that he expected Finance Secretary Teves would give strong support to programs in the BIR and the Bureau of Customs (BOC) to fight tax evasion and corruption. He said that efforts by the Finance Department, though critical, were not sufficient and that the GRP needs more consistent follow up action from the judicial sector. When authorities identify tax evaders or corrupt officials, the public needs to see prompt prosecutions and resolutions of these cases, he noted. Without that sense of finality, the GRP cannot create the deterrent effect so critical to changing current patterns, he admitted.

Finance Secretary Teves Focused on Fiscal Reform

13. (SBU) In the Charge's August 25 introductory call, Teves underscored that his long-term objective was to ensure a balanced budget by 2008 and that the expanded VAT would help significantly. He hoped that a favorable Supreme Court decision on the VAT's constitutionality would permit implementation by the first or second week of September. (Note: Supreme Court decided this case on September 1. Septel reports details. End note.) The delay since early July has already cost about 10 billion pesos in lost revenues. Although revenues from the expanded VAT are not included in the estimated 280 billion peso deficit for 2005, the best case scenario would now result in the expanded VAT reducing the deficit by 17.5 billion pesos for the remainder of this year. The decision to reduce petroleum duties (from 5 percent to 3 percent) would be 2 billion pesos less in revenue intake per month, so the net effect of the expanded VAT and petroleum tax reduction would be an additional 11 billion pesos in 2005 revenues, according to Teves's back-of-the-envelope calculation. He underscored that the key to maintaining progress would be the performance of the BIR and BOC, under his management.

14. (U) Teves estimated that government spending declined by 32 billion pesos (\$580 million) in 2005, and, with implementation of the expanded VAT, the deficit in 2005 would be about 180 billion pesos (\$2.7 billion). If oil prices stay within the \$65-70 bbl. range, the GDP growth forecast would be in the range of 5.0 - 5.3 percent, with higher growth associated with lower oil prices.

15. (U) Teves said he saw no need for new taxes in 2006. He wants to focus on the sale of government assets, improved tax collection, and better monitoring of performance in the government owned and controlled corporations (GOCCs). The government's recent divestiture of shares in the Philippine National Bank, he said, would send a strong signal to investors that the GRP wants to sell off more of the GOCCs. Echoing Tetangco's sentiments, he said that commercial banks need to consolidate and merge and that, with greater financial sector stability, risk premiums might be reduced.

Millennium Challenge Account (MCA)

16. (SBU) The Charge informally notified Teves that the Millennium Challenge Corporation had approved the GRP's

concept paper for the MCA Threshold Country Program. We would receive official notification soon. USAID Director added that the Philippines would now become eligible to submit a Threshold Country Plan for a possible initial grant to support fiscal reforms and anti-corruption programs designed to boost revenue capacity and other activities outlined in the GRP's concept paper submitted in June. Teves was very pleased that the Philippines could become an MCA Threshold Country and introduced Deputy Finance Secretary Roberto Tan as the GRP lead on MCA. Teves said he planned to meet with MCC officials when he is in Washington in September for the World Bank/IMF meetings. Teves underscored his government's commitments to fiscal reform and anti-corruption efforts.

Attracting Investment

17. (SBU) Teves interpreted the approximately 10 percent increase in the Manila stock market since the beginning of the year as a sign of investor confidence. Net portfolio capital inflows have reached about \$1.9 billion this year. However, he acknowledged that money moving in quickly can just as quickly move out and that foreign direct investment has hardly grown this year. He blamed low levels of infrastructure investment and continued fiscal weakness for the lackluster FDI record. Although remittance flows are very important, he said, the GRP needs to create more opportunities to channel OFW remittances into investment. Remittances do provide foreign exchange and funds to rural areas especially, but mostly for consumption, he added.

18. (SBU) Teves cited his priority legislative initiatives in Congress: a new securitization law that would further clarify legal protections for lenders and facilitate investment as well as legislation on insurance, capital markets, and pension funds. He said he would wait for a lull in Congress and then try to move quickly on legislation. He acknowledged that a number of recent Supreme Court and other court rulings had created difficulties for foreign direct investors but claimed that the Finance Department was unable to influence those situations. The Supreme Court ruling that the Clark Economic Zone's tax incentives were unconstitutional has affected 350 investors there, including firms from the United States, EU, and Japan, but this was a matter for the courts, he insisted. Teves also showed little interest in other ways to improve the business climate such as stronger IPR protection. He said that he would remain focused on fiscal reforms, especially improving revenue collection, and not on areas outside the direct authority of the Finance Department. The Charge commented that improving the business climate would reinforce investment inflows and that the MCA Threshold program could be especially useful in backstopping GRP efforts to improve the capacity of its revenue agencies.

Visit to New York to Boost Investor Confidence

19. (SBU) Tetangco and Teves plan to visit New York in mid-September with President Arroyo when she attends the UNGA meetings. They will meet with members of the financial community in New York, where the Philippines will probably soon try to raise additional funds through the sale of dollar-denominated government bonds. They want to update potential investors, including those in the bond market, on Philippine economic developments and to confirm GRP commitments to fiscal reform. They will also travel to Washington for World Bank/IMF meetings on September 24-25. Except for Teves's meeting with MCC officials, they have not made requests yet for meetings with USG officials.

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